IT 95-42
Tax Type: INCOME TAX
Issue: Unitary Apportionment
1005 Penalty (Reasonable Cause Issue)

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS	)	
v	)	No.
	)	FEIN:
	)	TYE: 3/31/89
XXXXX	)	
Taxpayers	)	

RECOMMENDATION FOR DISPOSITION

APPEARANCES: XXXXX, on behalf of XXXXX, et al.; Mr. Sean P. Cullinan, Special Assistant Attorney General, on behalf of the Department of Revenue.

SYNOPSIS: XXXXX (hereinafter referred to as the "taxpayer"), is a Delaware corporation whose principal place of business is located in Kansas. The taxpayer is engaged principally in the business of renting durable household goods, including furniture, kitchen appliances, and consumer electronics to the general public. XXXXX1 ("XXXXX1") is a holding company incorporated in Delaware and its commercial domicile is located in California. XXXXX1 wholly owns XXXXX2 ("XXXXX2"). XXXXX2 is a holding company incorporated in Delaware and its commercial domicile is located in Delaware. XXXXX2 wholly owns XXXXX.

A Notice of Deficiency was issued on January 6, 1993 for the fiscal year ended March 31, 1989 (the 1989 tax year) proposing a tax deficiency in the amount of $71,912 and a Section 1005 penalty (35 ILCS 5/1005), in the amount of $15,368, to which the taxpayer responded with a timely Protest on

March l, 1993. The only issue to be decided in this case, the taxpayer having waived the Section 1005 penalty issue by not protesting, is:

(1). Whether XXXXX1, XXXXX2 and XXXXX, as well as other affiliated corporations, operated on a unitary basis during the 1989 tax year?

A hearing was held in this matter on January 27, 1994. The parties also filed a Stipulation of Facts and Supplemental Stipulation of Facts. Simultaneous briefs were filed on behalf of the respective parties on April 10, 1994. Upon consideration of all the relevant case law, arguments, facts as stipulated by the parties, and evidence in the record, it is being recommended that the issue be decided in favor of the taxpayer and against the Department of Revenue.

FINDINGS OF FACT:

1. XXXXX, Inc. was incorporated in Delaware in 1983 and its principal place of business is located in Kansas. (Stip. #2). XXXXX is principally engaged in the business of renting durable household goods, including furniture, kitchen appliances, and consumer goods to the general public. (Stip. #3).

2. XXXXX (XXXXX1) is a holding company which was incorporated in Delaware and its commercial domicile is located in California. XXXXX1 wholly owns XXXXX2 (XXXXX2). (Stip. #4).

3. XXXXX2 is a holding company incorporated in Delaware and its commercial domicile is located in Delaware. XXXXX2 wholly owns XXXXX. (Stip. #5).

4. XXXXX1 (XXXXX1), timely filed a U.S. form 1120 on a consolidated basis for the 1989 tax year, including XXXXX1, XXXXX2, and XXXXX among its other filing affiliated corporations. (DOR Exh. 5).

5. XXXXX separately filed a timely Illinois Form IL-1120 for the 1989 tax year. XXXXX2 and XXXXX1 did not file Illinois income tax returns because they did not separately have nexus with Illinois and because they

take the position that they are not engaged in a unitary business with XXXXX. (Stip. #7).

6. The Illinois Department of Revenue audited the taxpayer and as a result of the audit it issued a Notice of Deficiency to XXXXX in the amount of $87,280 for the 1989 tax year, to which a timely Protest and Request for Hearing was filed. (DOR Exh. 9). The Notice of Deficiency proposed a tax deficiency in the amount of $71,912 and a penalty pursuant to 35 ILCS 5/1005 in the amount of $15,368. (DOR Exh. 8).

7. In 1987 XXXXX2 formed a wholly owned subsidiary, XXXXX2 for the sole purpose of acquiring all of XXXXX's stock. (Stip. #12.)

8. XXXXX was a publicly traded corporation prior to September 1, 1987. On that date XXXXX2 acquired all of XXXXX's stock by means of a tender offer. (Stip. #13).

9. Immediately after acquiring XXXXX's stock, XXXXX2 merged into XXXXX, with XXXXX being the surviving corporation. Thus, XXXXX became a wholly owned subsidiary of XXXXX2. (Stip. #14).

10. XXXXX2 acquired the funds used for the purchase price as follows: XXXXX1 , a limited liability company, made a public offering of its stock to raise the required funds. XXXXX1 contributed an amount equal to the purchase price (approximately $590,000,000) to the capital of its wholly owned subsidiary, XXXXX1 , which in turn contributed the purchase price to its wholly owned subsidiary, XXXXX1, which in turn contributed the purchase price to its wholly owned subsidiary, XXXXX2. Finally, XXXXX2 contributed $190,000,000 of the purchase price to XXXXX2's capital and loaned approximately $400,000,000, the remaining purchase price to XXXXX2 and XXXXX (the "XXXXX2"). (Stip. #15).

11. Due to the fact that XXXXX2 was immediately merged into XXXXX, XXXXX owed the $400,000,000 XXXXX2 after the acquisition. (Stip. #16).

12. XXXXX accrued interest expense totalling $43,471,831.79 in the

1989 tax year to XXXXX2 on the XXXXX2. XXXXX deducted this amount as interest expense in computing its apportionable business income on its 1989 Illinois income tax return. (Stip. #17).

13. XXXXX1 and XXXXX2 were holding companies that did not conduct active business operations. Other than its officers and directors, XXXXX2 had no employees of its own. XXXXX1 did have employees that it made available to XXXXX2 as needed in the 1989 tax year. (Stip. #18).

14. XXXXX2 and XXXXX1 shared office space in California, paying a combined rent of $6,186 for the 1989 tax year. (Stip. #19).

15. XXXXX shared no common officers, directors, or employees with XXXXX2 or XXXXX1. (Stip. #20).

16. XXXXX shared no common office facilities, selling facilities, manufacturing facilities, or transportation facilities with XXXXX2 or XXXXX1. (Stip. #21).

17. XXXXX shared no common communications, computer, or other equipment with XXXXX1 or XXXXX2. (Stip. #22).

18. XXXXX did not engage in any common purchasing, manufacturing, retailing, researching, advertising or marketing, training, or accounting with XXXXX1 or XXXXX2. (Stip. #23).

19. XXXXX did not lease or purchase any products from or lease or sell any products to XXXXX1 or XXXXX2. (Stip. #24).

20. XXXXX1 and XXXXX2 had no input in and exercised no control over XXXXX's day-to-day operations, including but not limited to XXXXX's purchasing, product line choices, retail methodology choices, research, advertising or marketing, capital (i.e., equipment) expenditures, personnel, accounting and legal functions. XXXXX performed all of these functions independently of XXXXX1 and XXXXX2, exercising its sole discretion in making any decisions with respect to all aspects of its operations. (Stip. #25).

21. XXXXX did not submit annual budgets to XXXXX1 or XXXXX2 for approval or review. (Stip. #26).

22. The only common functions performed by the taxpayers were the cash management function, cooperation in preparing a consolidated federal income tax return, and insurance.

a. XXXXX1 provided a coordinated cash management function whereby XXXXX1 loaned any cash needed for XXXXX's operations and collected any excess cash from XXXXX on a daily basis. In the 1989 tax year, XXXXX2 accrued interest income of $1,305,294 from XXXXX1 and XXXXX accrued interest income of $2,327,094 from XXXXX1.

b. The taxpayers shared common insurance policies.

c. The taxpayers each prepared their own financial information and forwarded it to XXXXX1, the parent of the United States affiliated group, for incorporation into the group's consolidated federal income tax return. XXXXX itself prepared and filed its own state tax returns. (Stip. #27).

23. XXXXX1 filed a combined return as part of a unitary group in the State of California in the 1989 tax year. The return contains a schedule indicating the corporations that XXXXX1 included in the unitary group. XXXXX and XXXXX2 were not included by XXXXX1 in the unitary business group with XXXXX1. (Supp. Stip. #1).

24. XXXXX filed a corporate income tax return on a separate basis in Delaware in the 1989 tax year. (Supp. Stip. #2).

25. XXXXX2 was exempt from Delaware corporate income tax in the 1989 tax year pursuant to Delaware Code Annotated {1902(b)(8). XXXXX2 was required to file a franchise tax return and an informational return in the 1989 tax year pursuant to Delaware law. XXXXX2 did not file a separate corporate income tax return in any other state. XXXXX2 was not included as a member of a unitary business group with any affiliate in a combined

return in the 1989 tax year. (Supp. Stip. #3).

26. A formal hearing was held in this matter at the Chicago offices of the Department of Revenue on January 27, 1994 before Hollis D. Worm, Administrative Law Judge. Representing the Department was Sean Cullinan, Special Assistant Attorney General. The taxpayer was represented by XXXXX, of the law firm XXXXX.

CONCLUSIONS OF LAW: 35 ILCS 5/1501(a)(27) defines a unitary business group as:

> . . . a group of persons related through common ownership whose business activities are integrated with, dependent upon and contribute to each other.

The unitary business concept has developed as a balance between a taxing state addressing the economic realities of a given corporate structure and the federal constitutional parameters regarding taxation of interstate activity. The United States Supreme Court has long sanctioned the unitary business principle. Mobil Oil Corp. v. Commissioner of Taxes of Vermont, (1980) 445 U.S. 425, 100 S. Ct. 1223, 63 L. Ed. 2d 510, as well as the necessarily resulting apportionment of income generated by the unitary group to a taxing state as determined by a statutory formula.

The unitary concept is a prime example of substance over form in the area of taxation. As the Illinois Supreme Court stated in Caterpillar Tractor Co. v. Lenckos, et. al.(1981) 84 Ill. 2d 102, 417 N.E. 2d 800, 156 Ill. Dec. 329: "[a] unitary business operation is one in which there is a high degree of interrelation and interdependence" between a corporation, its subsidiaries, and affiliated corporations. Thus a "unitary business group" is defined in terms of integration, dependence, and contribution. The Illinois statutory scheme provides that

> [u]nitary business activity can ordinarily be illustrated where the activities of the members are: (1) in the same general line (such as manufacturing, wholesaling, retailing of tangible personal property, insurance, transportation or finance); or (2) are steps in a vertically structured enterprise or process (such as the steps involved in the production of natural resources,

> which might include exploration, mining, refining, and marketing); and, in either instance, the members are functionally integrated through the exercise of strong centralized management (where, for example, authority over such matters as purchasing, financing, tax compliance, product line, personnel, marketing and capital investment is not left to each member). 35 ILCS 5/1501 (a)(27).

XXXXX1, XXXXX2 and XXXXX meet the common ownership requirement. With respect to the corporations being in the "same general line" or "steps in a vertically structured enterprise or process", because of my determination that XXXXX1, XXXXX2 and XXXXX are not functionally integrated through the exercise of strong centralized management, a finding on either of these requirements is rendered irrelevant.

My determination that XXXXX1, XXXXX2 and XXXXX are not functionally integrated through the exercise of strong centralized management is all but controlled by the terms of the Stipulations between the taxpayer and the Illinois Department of Revenue.

The parties have stipulated that XXXXX1 and XXXXX2 had no input in and exercised no control over XXXXX's day-to-day operations, including but not limited to XXXXX's purchasing, product line choices, retail methodology choices, research, advertising or marketing, capital (i.e., equipment) expenditures, personnel, accounting and legal functions. XXXXX performed all of these functions independently of XXXXX1 and XXXXX2, exercising its sole discretion in making any decisions with respect to all aspects of the operations. XXXXX did not submit annual budgets to XXXXX1 or XXXXX2 for approval or review.

XXXXX shared no common officers, directors, or employees with XXXXX2 or XXXXX1. XXXXX shared no common office facilities, selling facilities, manufacturing facilities, or transportation with XXXXX2 or XXXXX1. XXXXX did not engage in any common purchasing, manufacturing, retailing, researching, advertising or marketing, training or accounting with XXXXX1 or XXXXX2. XXXXX did not lease or purchase any products from or lease of

sell any products to XXXXX1 or XXXXX2.

XXXXX1 did provide a coordinated cash management function whereby XXXXX1 loaned any cash needed for XXXXX's operations and collected any excess cash from XXXXX on a daily basis. In addition, the taxpayers shared common insurance policies.

> Under the regulations of the Illinois Income Tax Act, a finding of "strong centralized management" cannot be supported merely by showing that the requisite ownership percentage exists or that there is some incidental economic benefit accruing to a group because such ownership improves its financial position. Both elements of strong centralized management, i.e., strong central management authority and the exercise of that authority through centralized operations, must be present in order for persons to be a unitary business group under IITA Section 1501(a)(28). 86 Illinois Administrative Code, Chapter I, {100.9900(g).

In ASARCO v. Idaho State Tax Commission (1982) 458 U.S. 307, 102 S. Ct. 3103, 73 L. Ed. 2d 787, the parent corporation owned over fifty percent of an Australian corporation (M.I.M.) engaged in similar mining-related activity. The United States Supreme Court found that:

> [a]lthough ASARCO has the control potential of manage M.I.M., no claim is made that it has done so. As an ASARCO executive explained, it never even elected a member of M.I.M.'s board. . . . In addition to forgoing its right to elect directors, ASARCO similarly has taken no part in the selection of M.I.M.'s officers -- a function of the Board of Directors. Nor do the two companies have common directors or officers. The [Idaho] state trial court found that M.I.M. "operates entirely independently of and has minimal contact with" ASARCO. As the business relation is also minimal, it is clear that M.I.M. is merely an investment.

The ASARCO Court found facts establishing the simple investor-investment relationship. Similarly, in F.W. Woolworth Co. v. Taxation and Revenue Department, (1982) 458 U.S. 354, 102 S. CT. 3128, 73 L. Ed. 2d 819 argued and decided together with ASARCO, the Court reiterated the necessity of actual, practical interdependence:

> [New Mexico] state court's reasoning would trivialize this due process limitation by holding it satisfied if the income in question "adds to the riches of the corporation. . . ." Income from whatever source, always is a "business advantage" to a corporation. Our own cases demand more. In particular, they specify that the proper inquiry looks to "the underlying unity or diversity of business enterprise."

Accordingly, applying the parameters set forth by the United States Supreme Court, as well as the Department's own regulation, to the facts as stipulated by the parties and the record of this case, XXXXX1, XXXXX2 and XXXXX did not meet the test of being functionally integrated through the exercise of strong centralized management. Therefore, it is being recommended that the issue be decided in favor of the taxpayer and against the Department of Revenue.

Given the finding reached above, this recommendation does not reach the alternative argument raised by the taxpayer. The taxpayer had filed a Motion For Leave to Amend Protest in order to make the alternative contention that even if XXXXX1 and XXXXX2 were found to be unitary with XXXXX, they constitute financial organizations within the definition of "financial organization" contained in 35 ILCS 5/1501(a)(8). They argued that both corporations fell within the category of "investment company" within that definition.

Under this alternative argument, if both corporations were "financial organizations", they would be required to apportion their income using the one factor apportionment formula prescribed in section 304(c) rather than the standard three factor apportionment formula under section 304(a). As a result, as defined by 35 ILCS 5/1501(a)(27), XXXXX1 and XXXXX2 would be prohibited from being considered as members of a "unitary business group" with XXXXX and their income could not be added to XXXXX's apportionable business income.

On August 13, 1993, this Administrative Law Judge denied that motion as untimely and waived. To preserve their rights on appeal, evidence was introduced by the taxpayer at the hearing and legal arguments were presented in the Taxpayers' Brief in Support of Protest (pp. 25-28) regarding the issue of whether XXXXX1 or XXXXX2 were "investment companies". Because of my determination that XXXXX1, XXXXX2, and XXXXX are

not engaged in a unitary business activity under the facts as stipulated by the parties, a finding on this alternative issue raised by the taxpayer is rendered irrelevant.

RECOMMENDATION: In accordance with the foregoing, it is being recommended that the Director of Revenue issue his Notice of Decision withdrawing the Notice of Deficiency issued on January 6, 1993 in its entirety.

Hollis D. Worm
Administrative Law Judge

6/8/95